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Federal Deficit: Changing Trends

Marion G. Wrobel
Economics Division

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FEDERAL DEFICIT: CHANGING TRENDS

ISSUE DEFINITION

In fiscal year 1984-85, the Public Accounts deficit of the federal government reached an unprecedented $38,324 million, amounting to 8.6% of the Gross Domestic Product (GDP) for the corresponding calendar year. Three years earlier, the federal deficit had stood at $14,872 million, or 4.2% of GDP. The federal government has not balanced its budget -- let alone run a surplus -- since 1970-71, when measured on a Public Accounts basis. Deficits in the latter part of the 1970s were significantly higher than in the first part of that decade and they have ballooned even further since the 1981-83 recession. Furthermore, the accumulation of debt, which had declined as a proportion of GDP until the mid 1970s, has grown at a rapid pace in the 1980s. As of 31 March 1975, net public debt accounted for 16.8% of GDP. Today it is over 52% of GDP and still increasing.

This government has put considerable emphasis on its policy of controlling the deficit and debt. This paper examines how these two variables have changed over time, the major influences affecting their size and the fiscal principles through which the federal government hopes to control both.

BACKGROUND AND ANALYSIS

There are two popular methods of presenting government expenditures and revenues: the Public Accounts (PA) presentation is designed to provide parliamentarians with relevant financial data; the

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National Accounts presentation is designed to measure the impact of government spending and revenues on expenditure and income flows in the economy. The National Accounts measure of the deficit tends to be smaller than the PA measure. Both, however, have virtually identical patterns over time. The discussion here will consider only Public Accounts data since they are most familiar to parliamentarians. All statistics will be consistent with those of the Reference Tables in the Budget Papers. For any year cited, the reference is to the fiscal year ending 31 March of that year.

Although references to deficits are usually in dollar terms, this can be misleading. This discussion will therefore refer to deficits, debt, etc. as ratios to the Gross Domestic Product (GDP).

From 1971 to 1975, the PA deficit was less than 2% of GDP. It rose steadily to over 5% of GDP in 1979. After declining for several years it increased sharply to 8.6% in 1985. Since the federal government made deficit reduction an important part of its fiscal policy, we have seen the deficit decline to 6% of GDP. The latest federal budget projected a further decline, to about 4% of GDP by 1990.

A. Measuring Deficit Growth: Revenues and Expenditures

The deficit measures the shortfall of revenues over expenditures in any year. In this sense, it is simply a summary statistic. The changing pattern of the deficit is then directly a consequence of changing patterns in revenues and expenditures.

The early 1970s were years of expanding government; federal expenditures rose by an amount equal to almost 3% of GDP, yet, since tax revenues also increased sharply in this short period, the deficit increased only marginally. After 1975, however, taxes fell dramatically, leading total revenues to decline from a high of 19.2% of GDP to a low of 15.2% of GDP in 1980. In 1976, expenditures increased by more than 1% of GDP and then fell by about 2% of GDP by 1980. Such changes in the pattern of expenditures and revenues set the stage for relatively large deficits. By the end of the 1970s, federal expenditures accounted for a greater share of GDP than at the start of the decade, even though government growth had

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moderated. Rather than financing this growth through increased taxes, the government financed it through increased deficits.

From 1980 to 1982, both expenditures and revenues grew slightly, and the deficit was relatively stable. After 1982, the effects of the recession were felt. From then until 1985 revenues declined by about 1% of GDP. Expenditures, however, increased substantially, by more than 3% of GDP, peaking at 24.5% of GDP in 1985. The deficit reduction plans of this government in the short run have included expenditure cuts and tax increases. From 1985 to 1987, tax revenues, which increased by about 1% of GDP, were the primary source of revenue increases. Over the same period, expenditures fell by almost 2% of GDP. The longer-term projections indicate that expenditure reductions are to bear the brunt of deficit cutting. By 1990, tax revenues as a proportion of GDP should fall slightly, to become lower than they were in 1971. Although expenditure cuts form a significant part of the deficit reduction plan, expenditures and deficits will continue to be high by historical standards. Expenditures in 1990 will be about 3.5% of GDP lower than in 1985: this percentage is still higher than it was before the last recession.

These secular patterns are presented in Figure 1. The difference between total expenditures and total revenues constitutes the deficit for each year.

1. The Primary Deficit

If we consider the government's ability to pay for its programs with tax revenues, the "primary deficit" is the difference between program spending and tax revenue. It can also be calculated as the total deficit less net debt charges. Figure 2 presents actual and projected statistics for the deficit and the primary deficit on a PA basis.

Until 1978, changes in the deficit were directly related to changes in the primary deficit. For the next few years, the primary deficit fell much faster than the total deficit. Net debt charges were becoming an increasingly important factor in determining the growth of the deficit.

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Figure 1

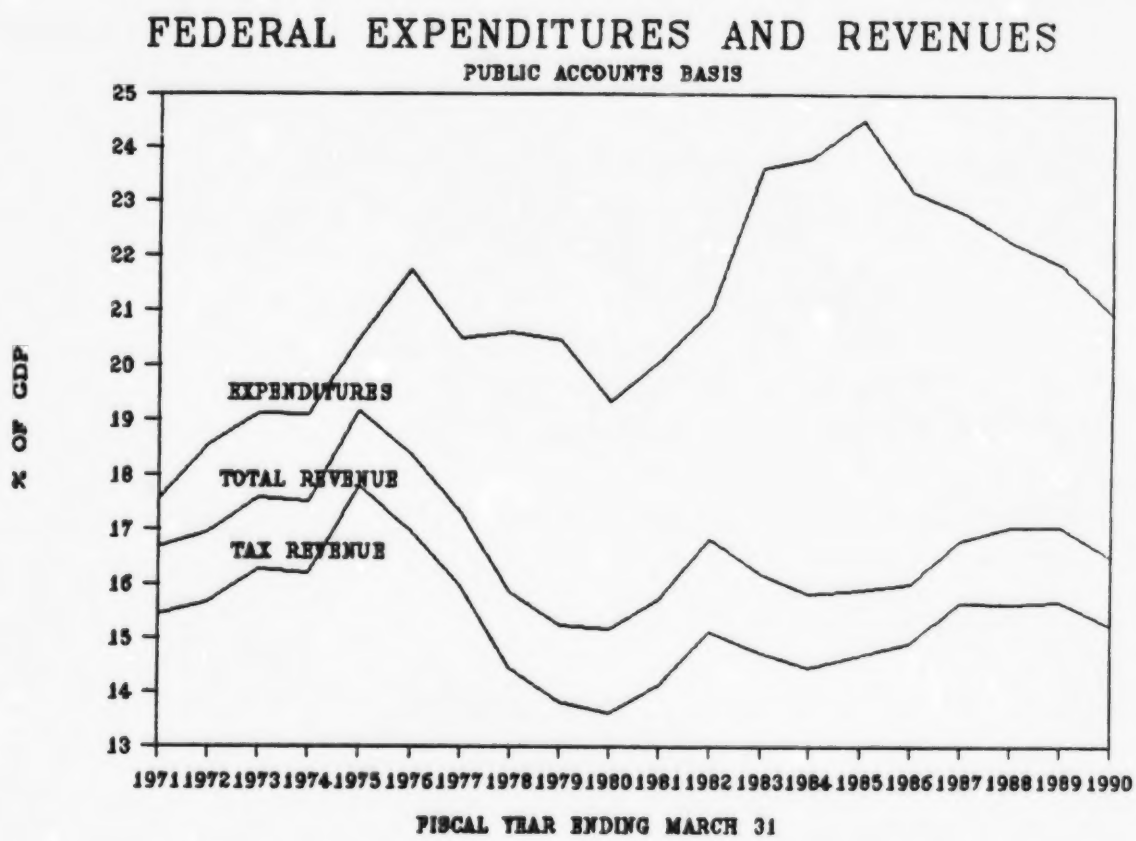

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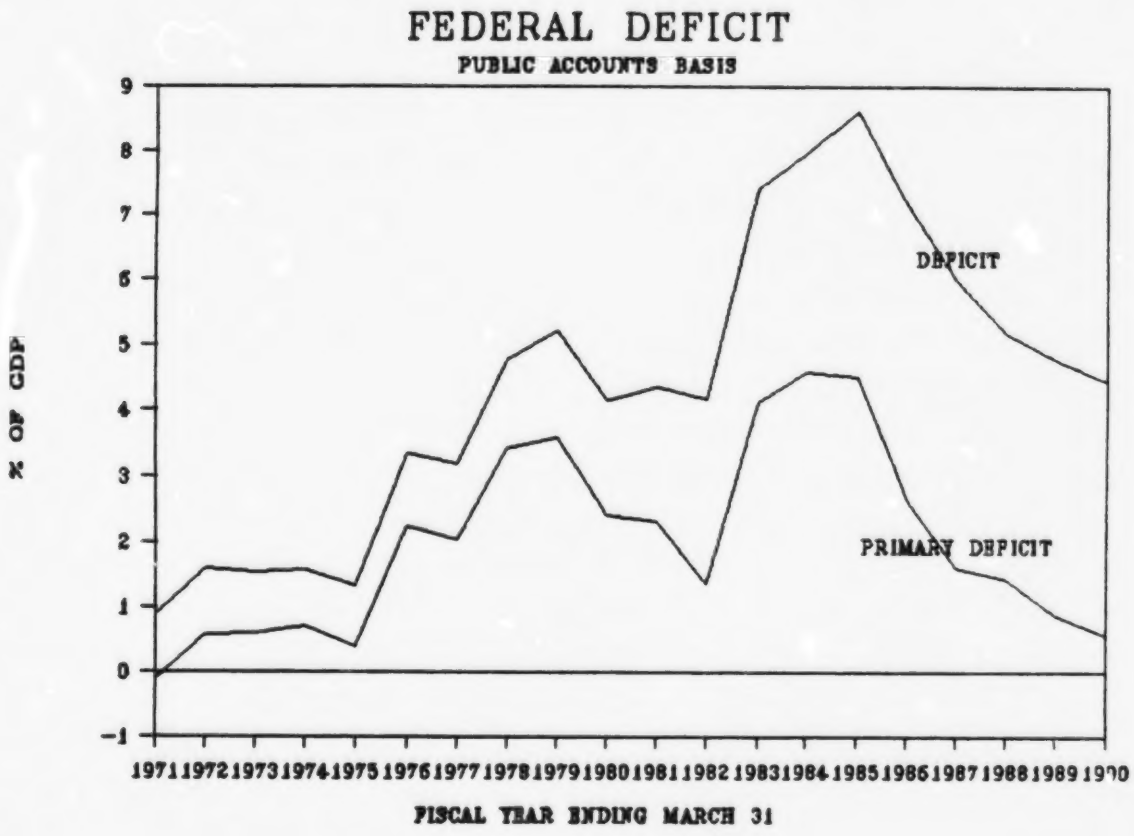
Figure 2



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From 1982 to 1983 the deficit rose sharply, largely in response to the recession; Figure 2 indicates that it was largely an increase in the primary deficit which was the cause. After 1983, it is clear that the primary deficit was becoming less influential on the budgetary deficit of the federal government while net debt charges were becoming more so.

The primary deficit is more sensitive than the total deficit to changes in the government's fiscal stance, and to changes in economic conditions. Since the present government was elected, the primary deficit has fallen continually. It is now less than 2% of GDP and is projected to continue falling, reaching about 0.5% of GDP by 1990. Primary deficit reduction is projected to take place much more slowly than in the 1985 to 1987 period.

2. Debt Charges

The net debt charge in any year is determined by the average stock of net debt outstanding, multiplied by the average interest rate applied to that debt. Some of the debt has a long term to maturity and the interest rates for that component may be much higher than prevailing rates. Newly issued debt, however, will have interest rates which do reflect current market conditions. The faster the increase in the stock of debt, the greater will be the proportion of it subject to prevailing interest rates.

The net debt outstanding at time is simply the sum of past deficits on a PA basis. Net debt charges are therefore related both to current interest rates, usually cited in discussions of the deficit, and to past deficits, usually downplayed. If the federal debt comprises long term fixed rate debt, however, a sharp rise in interest rates will have little immediate impact on net debt charges in a world of low deficits because only small amounts of new debt have to be financed at current rates. With large deficits, however, a large new stock of debt must be financed, and at prevailing rates.

A debt load which is rapidly growing as a result of high annual deficits, then, makes the budgetary stance of the government more

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sensitive to temporarily high interest rates because it has a higher proportion of debt which is subject to prevailing interest rates.

3. Program Expenditures

Total expenditures, less debt charges, constitute total spending on government programs. It is, of course, spending on such programs which is at the heart of modern government. During the heyday of government expansion, 1971 to 1976, it was the increase in program spending which led to overall spending growth. In 1971, program spending amounted to 15.5% of GDP and 87.9% of total federal spending; at its peak, in 1976, it amounted to 19.4% of GDP and 89% of total spending.

Since then, program spending's share of total outlay has declined. Even during the recession, it did not achieve the relative share it held in 1976. By 1990, program spending is projected to account for about 75% of total spending, slightly lower than today's share of 77%.

Program expenditures can be further disaggregated in a number of ways. In recent federal budgets, the Department of Finance has divided expenditures into statutory and non-statutory expenditures. In 1985, statutory expenditures accounted for 55.4% of total program expenditures and by 1989, are expected to rise to 57.9%.

No such disaggregation is available for the years before 1984; changed accounting definitions make a longer-term series potentially misleading. Nevertheless the major statutory expenditures are obvious: UIC benefits, OAS benefits, Family Allowances, Canada Assistance Plan, the cash portion of Established Programs Financing and fiscal transfers. According to a Bank of Canada study, most of the increase in expenditures before 1984 can be accounted for by increased spending on statutory programs. As is evident from budgetary statistics, this trend has continued since 1984.

B. The Growth in the Debt Load

For the two decades ending in 1975, federal net debt had been slowly declining as a proportion of GDP. It reached a low of

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about 17% in 1975, as compared with 36% in 1956. (During World War II it had exceeded 100% of GDP but this percentage was quickly reduced after the war.) Today, federal net debt exceeds 53% of GDP and is still growing. Indeed since 1982, net debt has grown by an amount in excess of 25% of today's GDP.

The level of net debt equals the cumulative total of past deficits on a Public Accounts basis. It is, then, a stock measure of past annual flows. Net debt therefore provides an alternative view of annual government deficits and might be useful in generating other perspectives on fiscal policy.

Figure 3 highlights the rapid growth of federal government net debt in the 1980s. As at 31 March 1982 it stood at 28.25% of GDP. By 31 March 1987 it had reached 51.8% of GDP, as a result of the very high annual deficits experienced in the intervening years. Net debt had been growing far faster than Gross Domestic Product. The projections for the subsequent three fiscal years show moderate increases in the debt to GDP ratio. The goal of the federal government is to reduce this ratio, starting in fiscal year 1991-92.

The relationship between debt growth and deficits can be demonstrated by the following relationship:

(1) The change in (DEBT/GDP) = (Primary Deficit)/GDP
+ (Debt/GDP)*(interest rate - GDP Growth)

The ratio of debt to GDP increases directly as a result of the ratio of primary deficits to GDP. The increase is also related to the ratio of existing debt to GDP, multiplied by the difference between the interest rate charged on the debt and the growth rate of GDP. If the interest rate charged on outstanding debt is equal to the rate of GDP growth, then the debt to GDP ratio can be stabilized by financing all program spending through taxes: i.e., running a zero primary deficit. If the interest rate charged on outstanding debt exceeds the rate of GDP growth, then a primary surplus must be realized for stabilization. To reduce the ratio of debt to GDP, even larger primary surpluses must be achieved.

It is useful to examine this relationship between the ratio of debt to GDP, the primary deficit, interest rates and GDP growth in order

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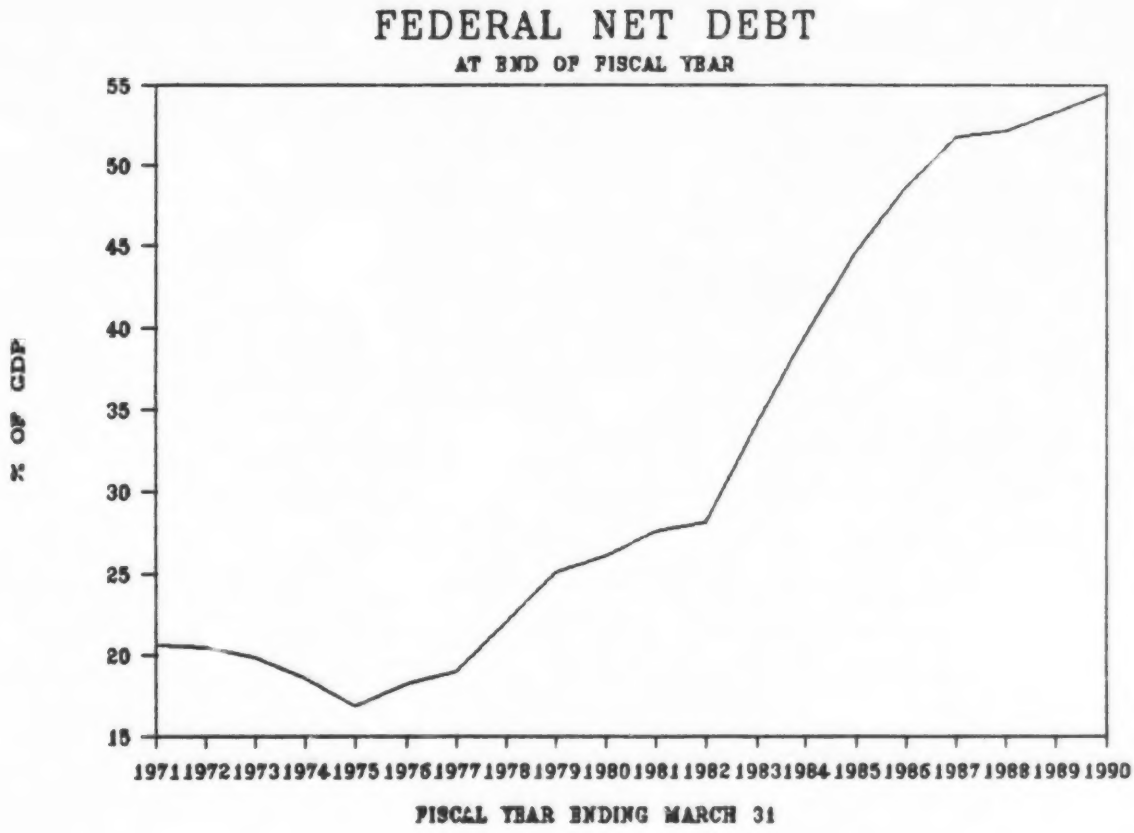
Figure 3



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to translate the fiscal principles guiding this government into deficit constraints. As set out in the recent federal Budget, debt growth is to be reduced to a level no higher than GDP growth and after 1992, debt is to grow more slowly than GDP.

These conclusions about the primary deficit say nothing about the overall size of the deficit which would be needed to stabilize the debt to GDP ratio. That would depend upon the target debt ratio set by the federal government. To maintain a stable debt ratio, the following relationship would hold:

(2) Deficit/GDP = (Debt/GDP)*GDP Growth

If the debt to GDP ratio is 53% and GDP is growing at 6% per year, a deficit equal to 3.2% of GDP will stabilize the debt ratio. If the debt to GDP ratio is only 25%, the deficit cannot exceed 1.5% of GDP. A 1985 paper on the deficit issued by the Minister of Finance proposed another fiscal goal: to reduce the debt to GDP ratio to no more than 25% of GDP, a level which existed prior to the 1980s.

Once the long-run target debt to GDP ratio is achieved, it can be maintained by running deficits which do not exceed about 1.5% of GDP, based on a 6% growth rate. But, though it could maintain it, such a deficit would not be enough to achieve that target in the first place. For example, if interest rates match GDP growth rates, the debt ratio can be reduced by two percentage points per year by running a primary surplus equal to 2% of GDP. It would then take about 15 years to achieve the long-run target after the short-run target had been achieved in 1992. During this transition to the long-run target, annual deficits would have to be about three percentage points less than they are today, i.e., no more than 2% of GDP. If interest rates are less than GDP growth then the long-run target can be achieved faster or through the use of smaller primary surpluses.

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C. Deficit Trends in 1988-89

For the first four months of this fiscal year, i.e., April to July 1988, the budgetary deficit stood at $6,672 million, 23% lower than the corresponding deficit last year. There are two reasons why this fall in the deficit may not accurately portray the deficit position for the entire year. In the first place, monthly revenues and expenditures are subject to wide fluctuations. More important, however, is the impact of tax reform on tax revenues. Tax withholding up to July was based on the old tax system, even though actual tax liabilities accrued on the basis of the reformed rate structure. In August of this year, with income tax withholding based on the reformed tax structure, the monthly deficit exceeded the corresponding deficit for the previous year. It is likely that future monthly deficit figures will not paint as rosy a picture as did deficit figures in the early part of this fiscal year.

PARLIAMENTARY ACTION

The size of the federal deficit is affected every time the federal government undertakes some spending measure or alters the system of taxation. Virtually all government measures therefore affect the deficit. Approximately once every year, the Minister of Finance presents a budget in which the government's future spending and taxation plans are outlined.

Selected Budgets and Projected Deficits

Hon. D.S. Macdonald, May 1976, $5,000m for1976-77: $6,297m actual.
Hon. J. Chrétien, April 1978, $10,900m for 1978-79: $12,617m actual.
Hon. J. Crosbie, December 1979, $11,200m for 1979-80: $11,501m actual.
Hon. A.J. MacEachen, June 1982, $19,800m for 1982-83: $27,816m actual.
Hon. M. Lalonde, February 1984, $29,600m for 1984-85: $38,324m actual.
Hon. M. Wilson, February 1986, $29,500m for 1986-87: $30,605m actual.
Hon. M. Wilson, February 1987, $29,300m for 1987-88: $28,083m actual.
Hon. M. Wilson, February 1988, $28,900m for 1988-89.

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June 1987 - The federal government tabled its White Paper on tax reform. This reform is designed to alter the distribution of tax liabilities between taxpayers and types of income. It is to be revenue neutral and so have no direct effect on the deficit.

December 1987 - The federal government announced its National Strategy on Child Care which includes an enhanced Deduction for Child Care Exemptions, an increased Child Tax Credit for families without receipts for child care expenses and new cost-sharing arrangements with the provinces. These measures are expected to cost the federal government $5,400 million over the next seven years.

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Prince, M.J., How Ottawa Spends, 1987-88: Restraining the State, Methuen, Toronto, 1987.